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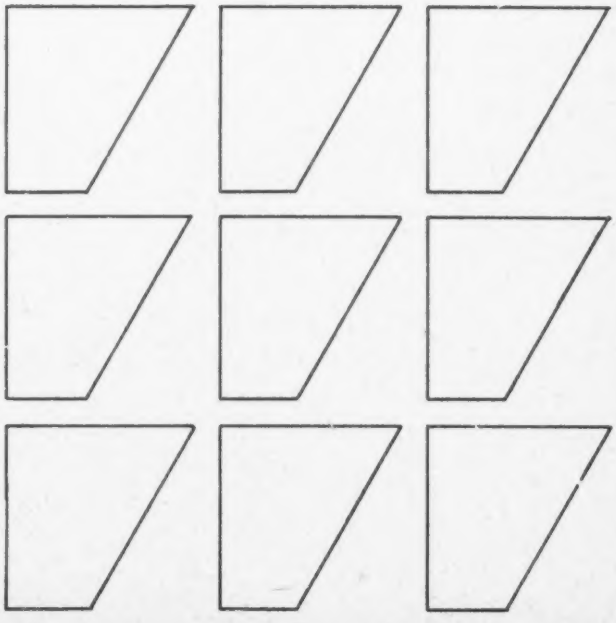
THE REGULATION OF FOREIGN BANKS: Policy Formation In Countries Outside The United States

By Adrian E. Tschoegl



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Summary

This paper's subject is the political economy of the regulation of foreign banks in countries other than the United States. We investigate the following two questions:

1) What are the major types of regulations?
2) What are the political and economic forces that cause the observed treatment of foreign banks in each country?

The intent is to investigate the nature and determinants of the regulations facing foreign banks. Our emphasis is on the regulations, and not on the characteristics of the various countries.

Our methodology is extremely simple. First, we categorize and incorporate into an ordinal scale the regulatory schemes of various countries vis-a-vis foreign-owned banks. Next, we relate the resulting variable to various country-specific characteristics which we hypothesize to have a bearing on the decision of which policy a country will adopt. The ten factors examined are: the government's desire for control, opposition to dependence on foreigners, the domestic banking industry, concern for depositor safety, relations with other governments, the role of foreign banks as sources of funds, trade promotion, reciprocity, the enhancement of domestic financial markets, and the desire to create a financial center.

One impression that emerges from the study is that the key consideration in determining a country's position on foreign bank entry and operations is what it perceives to be the costs of such activities, rather than the benefits. Benefits seem to have only a slight effect, since it is possible to gain many of these while still being highly restrictive.

Some countries, primarily those with socialized banking systems, object to foreign banks because they are, or would act like, private institutions. A number of countries with essentially private banking systems oppose foreign banks simply because they are foreign. They fear that their banking systems will become dominated by foreign institutions.

In the case where the government is concerned with retaining control, the underlying cause is political—the country's view of the proper role of the state. In the case of dependence, the causes

appear to derive from historical patterns of investment, as well as the political and economic relations between states.

In addition to these basic sources of attitudes towards foreign banks, the nature of the domestic industry seems to have an effect. The regulatory authorities are responsible for the stability of the banking system and depositor safety. They may restrict foreign bank operations or entry in support of these aims. They may also fear that foreign bank will not respond to government policies as do local banks, and may undermine patterns of cross-subsidization. Finally, regulators may be captured by the institutions they regulate. However, it is hard to separate these cases from those where regulators are protecting a cartel of inefficient producers because of public policy concerns.

The results of this essay suggest the following very simplified model of the regulation of foreign banks, which we would consider as a working hypothesis for further research. We can think of each country as asking itself three questions, in order:

Q1. Will we permit domestic private ownership in the domestic banking sector?
Q2. Will we permit foreign ownership in the domestic banking sector?
Q3. Given our answer to one and two above, do the remaining benefits outweigh the remaining costs, or vice-versa?

If the country's answer to either of the first two questions is "No," then one can expect that it will be at best restrictive towards foreign banks, and probably closed. If its answer to both of the first two is "Yes," then it will probably be open. In either case, the degree of restrictiveness, i.e., distance from the extreme position, will depend on the country's assessment of its answer to the third question, the residual cost/benefit considerations. That is, countries have political-economic attitudes that incline them towards one polar position or the other, i.e., towards being closed or open. Consideration of benefits from entry may move some countries that are oriented towards the closed end of the spectrum, towards the middle. Similarly, the costs of openness either to the industry or to the country will push some countries which tend to be open towards greater restrictiveness.

The model suggests that one can decompose what is commonly termed "political risk" into three components, each of which refers to changes in a country's response to the three questions above. While we do not specifically examine the process of change in regulations, the cases and the model suggest that each of these types of risk will manifest itself differently.

1. Introduction

This paper's subject is the political economy of the regulation of foreign banks in countries other than the United States. We investigate the following two questions:

1) What are the major types of regulations?
2) What are the political and economic forces that cause the observed treatment of foreign banks in each country?

The intent is to investigate the nature and determinants of the regulations facing foreign banks. Our emphasis is on the regulations, and not on the characteristics of the various countries. The inquiry is important for several reasons. First, the essay's concerns are topical, though not new [see, Wallenberg, c. 1920]. Second, if, as seems likely, the reduction of barriers to direct investment in service industries becomes the object of international negotiation, the success of the negotiators will depend in part on their understanding of why countries pursue the policies they do. Third, a comprehensive theory of regulation must be grounded in the analysis of the situation throughout the world, and not just that in liberal, developed countries.

The U.S. Treasury Department has recently released a study by the Comptroller of the Currency (hereafter referred to as the Comptroller's report or study) of the regulation of foreign banks in countries other than the U.S.[1] The study finds that U.S. banks have a "substantial degree of access to most financial markets abroad of importance to them, both in terms of initial entry and the powers they may exercise once entry has been accomplished." It concludes that American banks "generally receive equitable treatment abroad," though few countries would allow U.S. banks to acquire control of large indigenous banks. We use the report as the basic source of data on the regulations and, to a lesser degree, for more general information on specific countries.

Our methodology is extremely simple. First, we categorize and incorporate into an ordinal scale the regulatory schemes of various countries vis-à-vis foreign-owned banks. Next, we relate the resulting variable to various country-specific characteristics which we

[1] U.S. Treasury, *Report to Congress on Foreign Government Treatment of U.S. Commercial Banking Organizations*, Sept. 1979.

hypothesize to have a bearing on the decision of which policy a country will adopt. We draw the ten factors examined from theories of bargaining between MNCs and governments, and theories of regulation. Our intent is not to test the theories either individually or against each other, but rather to use them as sources of insight or perspective.

The techniques used to provide evidence for the existence and operation of the factor include comparisons of means without significance testing, cross-tabulations, and discussions of cases. Finally, we develop a qualitative static model of a country's choice of regulatory scheme and suggest some dynamic hypotheses.

We have chosen to eschew the usual practice of first presenting the model and then marshalling the relevant evidence. Doing so would imply that the research method was far more deductive than was actually the case. The true process was quite inductive.

The second section reviews some of the relevant literature on banking, relations between the host country and the multinational company, and regulation. The third section develops a typology of ownership and operating restrictions, and a combination of these. The fourth section discusses the determinants of the regulations. The final section suggests origins for some of the determinants, and attempts to integrate certain of the considerations.

2. Definitions and Theoretical Background

It is very hard to define banking, or even commercial banking. In essence, for this paper we simply accept each country's definition, even when these are inconsistent with each other. That is, we accept as commercial banking whatever the country implicitly or explicitly accepts as such. To the degree that a common definition emerges, it is that a commercial bank makes commercial loans, generally short term ones, and issues demand deposits.

Similarly, there is no consistent, generally accepted definition of regulation. We will take the term to mean government control of entry, or activities, in this case, as applied to foreign banks.

There is virtually no comparative literature on the national regulation of multinational companies (MNCs). Concern has focused either on the international regulation of MNCs. (i.e., Codes of Conduct) or on regulation within a single nation (e.g., Calvet [1977] and Lombard [1977]). Robinson's work on entry control systems [1976] and investment incentives [1979], Sachdev's article [1978] on investment policies, and Safarian's examination [1978] of the policies of developed countries towards multinationals are exceptions.

As far as banking is concerned, the situation is similar. There are few books that deal with the banking systems of several nations. Lees and Eng's study [1974] is descriptive without being comparative or analytical, and barely mentions the role of foreign banks. Baker [1978] describes bank regulation in a number of major countries and includes a chapter on deposit insurance schemes in countries other than the U.S. Though his primary interest is in banks' international activities, he does report on the activities and restrictions on foreign banks in the countries he examines (primarily Europe, the Middle East, and Japan). The *Financial Times'* Economics Advisory Group [1976] has made a study of banking and monetary policy in the European Economic Community (EEC), but analysis is limited to the latter concern. A recent article by Philip [1978] contrasts Anglo-Saxon financial and banking systems with the continental pattern, but unfortunately he discusses only West Germany, France, and Italy in any detail.

Weston [1980] surveys the regulatory practices with respect to monetary control of an eclectic group of nineteen countries. He does not find any "consistent pattern . . . along which domestic

banking regulation may be seen to be moving" (Weston [1980, p. 240]). This is not surprising given his sample and his lack of systematic comparison and analysis.

There are some works on the political economy of international banking (e.g., Aronson [1978]), and a very few national case studies: Kelly [1977] of the U.K., Fayerweather [1974] of Canada, Baum [1974] of the Caribbean, and Boyce and Lombard [1976] and Lombard [1977] of Colombia. However, the bulk of the literature on the regulation of foreign banks remains journalistic.

One can generally expect that a country will regulate foreign banks at least as strictly as domestic banks. Similarly, if a country is generally restrictive towards foreign direct investment, it will probably be at least as restrictive in the banking sector as in any other. Banking is considered a key sector in most countries and Kobrin [1978] has found it to be particularly prone to expropriation. Nevertheless, these considerations at best provide only bounds. They do not come to grips with the question of why the constraints on foreign banks relative to domestic banks are tighter in some countries than in others.

We can derive the reasons for differential regulation from two sources. The first is the literature on bargaining with multinational companies (MNCs) and government-MNC relations. The second is the theory of regulation.

The very idea of bargaining with MNCs implies that permitting them entry brings benefits to the host country, but also imposes costs on it. As Streeten [1976] and Morley [1975] discussed the concept, the benefits are technology, jobs, access to markets, etc., and the costs are the excess or monopoly profits that the MNCs earn.

In the case of banking, we would argue that excess profits are probably slight except where host-government policies have created market distortions from which foreign banks may benefit. The international banking industry is far from concentrated, and each potential investor country is represented by a number of banks [Tschoegl, 1981]. Nevertheless, as we discuss below, circumstances may lead to foreigners gaining monopoly profits in the short run. One can then expect authorities to act to curtail these quasi-rents.

The benefits from foreign entry include trade promotion, access to capital, access for domestic banks to other countries, enhancement of domestic financial markets, and creation of an international financial center. The idea of countries negotiating with foreign firms also introduces the question of relative bargaining strengths and the role of foreign governments.

The literature on host-country—MNC relations is dominated by the question of sovereignty, i.e., the locus of control (e.g.,

Vernon [1971]). Banking is generally considered a key sector, and a foreign presence may be considered problematic for both macroeconomic and firm-level reasons. One may expect a government to be concerned about the effect of the presence of foreign banks on monetary policy, exchange rates, capital inflows and outflows, and investment patterns. At the firm-level, bankers are often credited with the power of life and death over companies because of their ability to grant or withhold credit. This is especially so in countries without well-developed capital markets and with concentrated banking sectors. Countries may be loath to permit foreigners to exercise this discretion.

The traditional theory of regulation emphasizes the public purposes of regulation, in this case the creation of a banking system and the provision of a safe (default-free) asset for households. Thus the desire to assure the stability of the banking system and depositor safety could be a factor in determining host countries' attitudes towards foreign banks.

Chronologically, the traditional view was followed by another which emphasized the "capture" of the regulators by the regulated. Under this theory, regulation is perverted to protect a cartel, or at least inefficient producers, with no quid pro quo for consumers. More recently, Lee [1981] has proposed a theory of regulation that treats it as an exchange process in which an industry gives up the power of price determination in return for protection from entry. Either approach leads us to consider the possibility that restrictiveness towards foreign banks may be motivated by the domestic industry, or elements of it, pressing for protection from entry.

Finally, Posner [1971] stresses the taxation and subsidization functions of regulation. Peltzman [1976] further emphasizes the use of regulation for wealth redistribution and as the outcome of a political process. These suggest that foreign banks may be barred if their entry would threaten the viability of a system of cross-subsidization or income redistribution erected by regulatory authorities.

In Section 4, we discuss the determinants of regulation which these theories suggest. However, we must first develop some classificatory scheme that will permit the grouping of countries in terms of their policies.

3. Types of Restrictions

While it is relatively simple to discover the nominal laws and regulations in each country, determining the real situation is a more complex problem. Actual legislation forbidding a particular practice may be lacking, yet each foreign bank entering a country may have to promise the local central bank or other regulatory authority that it will subscribe to a perhaps unpublicized "gentlemen's agreement" which is fully as restrictive. Even more amorphously, all the foreign banks in a country may know that while some particular activity is not forbidden to them by law or regulation, the requisite prohibition would appear or they would be subjected to sanctions if they were to attempt to engage in it. These restrictions may be important, but are nearly impossible to identify in any systematic way. Conversely, regulations or laws may be promulgated but not fully enforced. This may be the consequence of post-legislation redefinition by the relevant government agencies, the impracticality of the regulations (i.e., difficulty of enforcement in principle), or the administrative weakness of the regulatory authorities [Naim, 1978]. Finally, laws or regulations may be applied equally to foreign and domestic banks, but have a differential impact on the two groups.

The typology of the regulation of foreign banks used in this paper is based primarily on the data in the Comptroller's report. The authors of the report have attempted to overcome the problem of identifying the actual situation by surveying U.S. banks with international operations and U.S. embassy personnel for their assessments.

In the abstract, it is simple to specify the polar categories of the classification. One extreme is a policy of complete prohibition on entry. The other is one of national treatment (complete nondiscrimination between domestic and foreign-owned banks).

Both extremes occur. Many countries prohibit any foreign bank presence, and others permit only representative offices. Absolutely national treatment, however, is particularly rare. On the one hand, even very open countries may retain some limitations. Safarian [1978] noted that the governments of the nine developed countries he examined had a position that could be described as protection of key firms against foreign takeover. As the Comptroller's study indicates, this policy extends to the foreigners' right to acquire major domestic banks. On the other hand, legal lacunae or even

government policy may lead to advantages for foreigners. It is therefore more useful to think in terms of approximate, rather than absolute, national treatment.

Between these extremes, classification becomes more difficult. Foreign banks may in effect be permitted to engage in almost all the same activities as do domestic banks, as long as they do not engage in some key activities (such as accepting demand deposits) and do not call themselves banks. Restrictions may also differ for different organizational forms (branch or subsidiary) or depending on the extent of foreign ownership. They may depend on the nationality of the foreign bank, whether it is government or privately owned, or the size of its operations. Finally, when foreign-owned banks or their branches are constrained in some respects relative to domestic banks, the regulatory authorities may release them from other requirements.

In certain cases where the authors of the Comptroller's report felt that the regulatory situation in a country with respect to the form of entry permitted was unclear or ambiguous, we have imposed our own subjective assesment. Where regulations discriminate among foreign banks (e.g., by country of origin), we have based classification on the treatment which would appear to be accorded the majority of the world's largest banks.

In the next two subsections we discuss ownership and operating restrictions separately. The third subsection combines these two dimensions.

3.1 Ownership

Classification is based on two questions, asked in sequence:

1) May foreign-owned banks open a branch?
2) May foreign-owned banks own a majority share in a local subsidiary, are they restricted to minority positions, or are any holdings in local subsidiaries barred?

These two questions together provide a six-fold categorization, with the categories arranged in order of restrictiveness. Since branching is usually the preferred form of entry, we consider a country that permits foreign banks to open branches but forbids any ownership of a local subsidiary as less restrictive than one that forbids the former but permits even wholly owned subsidiaries.[2] Countries that currently ban

[2] *Ibid.*, Chapter 5.

any entry, by either foreign or new domestic banks, are classified by their previous policy since the policy is nondiscriminatory with respect to origin. We do not factor in whether or not representative offices are permitted. Since, for most of the discussion below, we will be collapsing the existing categories even further, the need for extra precision is questionable.

As far as the second question above is concerned, we attempt to focus on the organizational form permitted or required for entry, and not on whether different rules apply to de novo entry than to acquisitions of major indigenously owned institutions. We take as given that almost no countries would permit the latter. This approach, however, involves us in further interpretation of the data, since the Comptroller's report does not always distinguish between the two possibilities. As a final qualification, the classification refers only to the restrictions governing domestic banking markets as defined by the country. We do not take into account regulations governing offshore banking units which countries may authorize and which are service analogs of manufacturing operations in export trade zones [McCarthy, 1979]. We also do not adjust the classification for those cases where foreign banks may establish financial subsidiaries provided that these do not call themselves banks and do not engage in certain retail banking activities.

Table 1 presents the classification, the number of countries falling into each category, and a weighted classification. This last consists of the proportion of the total gross national product (GNP) of the countries in the sample represented by the countries falling into each category. Clearly, there is a certain clustering towards the extremes.

The figures for the most restrictive category understate its true relative importance. A small number of countries such as Albania, Vietnam, and North Korea, among others, were omitted. These all happen to be highly restrictive towards foreign bank entry. Inclusion of the United States would probably not change the picture. Most states are quite restrictive, though some of the wealthiest are not. The states would thus be distributed over the spectrum of categories.

3.2 Operating

Operating restrictions provide countries with ways to tailor their regulation of foreign banks beyond the fairly crude limits given by ownership provisions. Operating restrictions take many forms. Table 2 lists some of the ones most frequently encountered.

Table 3 presents the classification of the countries into three categories on the basis of a subjective assessment of the severity of the restrictions. In the first category are those countries that have no, or seemingly only minor, restrictions. The middle group consists of the countries that permit foreign banks to operate but impose restrictions that would seem to be significant. The third group consists of those countries that ban foreign-owned banks outright, forbid them any but the most minor roles, or restrict them essentially to activities associated with international trade.

Operating restrictions appear a less popular regulatory mechanism (in terms of the number of countries adopting them) than

TABLE 1

Ownership Restrictions
(1979)

Branch	Subsidiary	No. of Countries (A)	Proportion (GNP-Weighted) (B)	No. of Countries (C)	Proportion (GNP-Weighted (D)	Classification (E)
Yes	Maj.	6 52	32%	4 52	32%	OPEN
	Min.	5 13	14%	3 17	15%	RELATIVELY OPEN
	No	4 4	2%			
No	Maj.	3 7	1%	2 28	10%	RELATIVELY CLOSED
	Min.	2 21	9%			
	No	1 41	43%	1 41	43%	CLOSED

Notes: 1) Numbers in upper right-hand corners in columns A and C are orderings.
2) Proportions are based on the number of countries falling in the category multiplied by their GNPs in U.S.$ billions in 1978 (or nearest year).

Source Comptroller's Report, 1979

ownership restrictions. This is probably a function of administrative convenience. Ownership restrictions require little or no surveillance of banks by regulatory authorities. When restrictions are imposed, limitations on deposit-taking and branching are among the most frequently used.

TABLE 2

Operating Restrictions

Restrictions On:	No. of Countries
Number of Branches	19
Access to Government Deposits or Business	19
Ability to Staff with Home-Country Nationals	11
Access to Retail Deposits	10
Liquidity, Capitalization, Leverage	8
Access to Central Bank Rediscount	5
Access to Government Export Financing Schemes	5
Access to Non-International Trade-Related Activities	4
Differential Tax Burden	3
Profit Remittances	2
Miscellaneous	8

TABLE 3

Operating Restrictions

# of Countries	Proportion (GNP-Weighted)	Classification
76	36%	Essentially Non-Discriminatory
31	29%	Restrictive
31	35%	Prohibitory

3.3 Synthesis

In this subsection we combine the results from the previous two to arrive at an overall classificatory scheme. We treat ownership and operating restrictions as two dimensions of regulatory policies. Figure 1 shows the resulting cross-classification. The divisions are subjective, but there is a rough ordinality to the categories. Thus we map the two dimensions back onto one, while limiting the number of categories.

The simple correlation between a country's numerical rating on the two dimensions of ownership and operating restrictions is 0.582. Cramer's V for Table 4 is 0.407.[3] A country's policies on the two dimensions generally appear highly consistent. Nevertheless, there are some cases of no relationship.

One such situation occurs when a country bars further foreign entry in any form, but permits existing foreign-owned banks the same scope of operation as domestic banks.[4] Mozambique represents an opposite case. There, entry per se is free, but the laws governing commercial banking are so restrictive as to have driven all but one nongovernment bank out of operation.

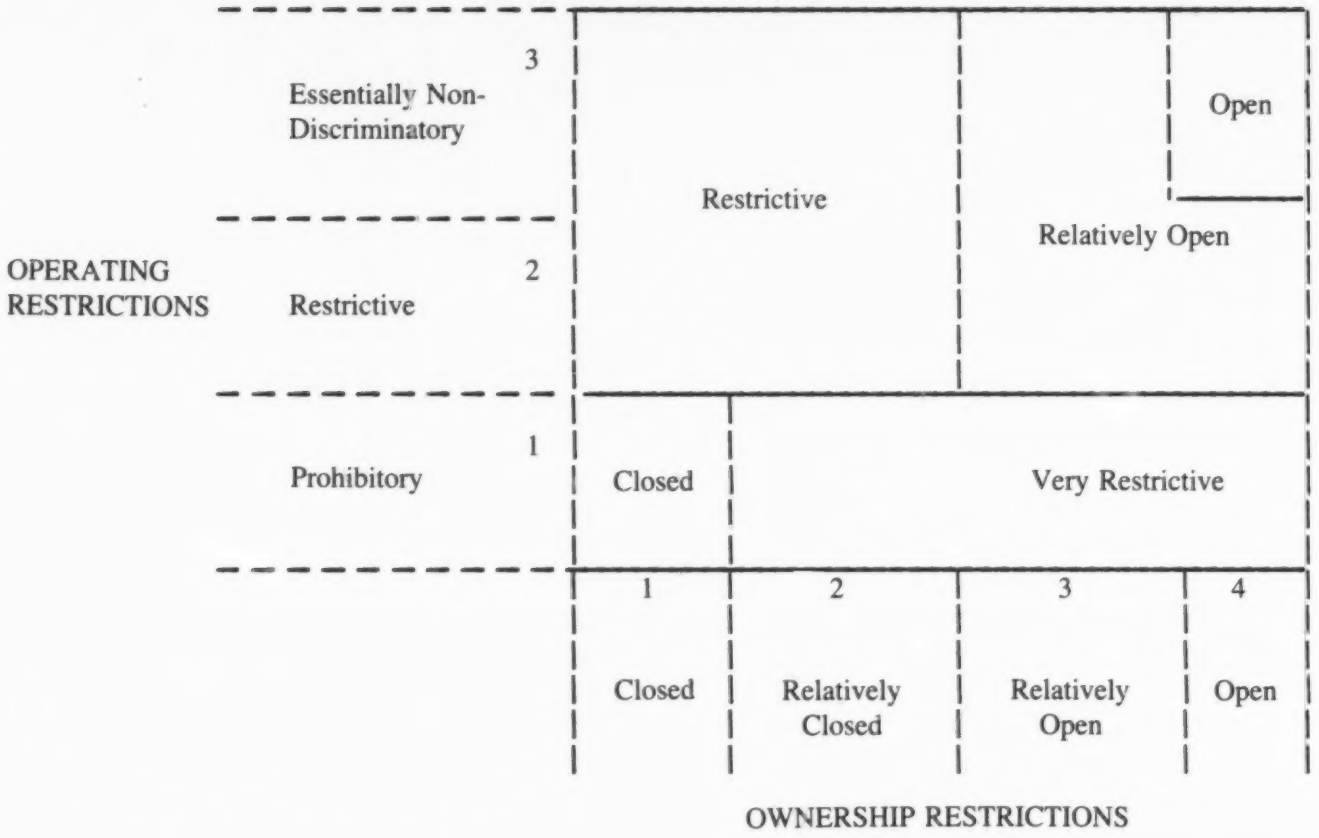
Table 5 parallels Tables 1 and 3. The bimodality we observed in Table 1 persists, at least from a GNP weighting point of

[3] Cramer's V is a measure of association for cross-tabulations. It is the square-root of the ratio of the chi-square statistic to the total number of cases, adjusted for degrees of freedom. By convention it is always positive.

[4] In some of the countries concerned, almost the entire banking system is foreign-owned, generally as a heritage of colonialism.

FIGURE 1

Typology of Regulatory Regimes



view. From the third column it is apparent that many small (in terms of GNP) countries must fall into the first and third categories, and some particularly large ones (i.e., the U.S.S.R.; and the P.R.C.) in the fifth. The Appendix lists all the countries in the study and their rating on the combined measure. In the tests below, because of the small number of cases in the second and fourth categories, we frequently combine categories.

TABLE 4

Cross-Classification by Ownership and Operating Restrictions

OPERATING RESTRIC-TIONS	3	7	16	7	46	76
	2	10	11	5	5	31
	1	24	1	5	1	31
	TOTAL	41	28	17	52	138
		1	2	3	4	TOTAL
		OWNERSHIP RESTRICTIONS				

$\chi^2 = 44.208$ ($p \leq .001$)
Cramer's V = 0.407

TABLE 5

Degree of Openness/Restrictiveness

Category	Number of Countries (a)	Proportion (GNP Weighted) (b)	Ratio (b)/(a)
5) Open	46	29%	0.63
4) Relatively Open	17	16%	0.94
3) Restrictive	44	19%	0.43
2) Very Restrictive	7	2%	1.16
1) Closed	24	34%	

4. Determinants of Regulation

The determinants are grouped under ten conceptual headings: control, dependence, the domestic banking industry, depositor safety, relations with other governments, source of funds, trade promotion, reciprocity, enhancement of domestic financial markets, and creation of a financial center.

4.1 Control

The literature on foreign direct investment is replete with references to the problems that the presence of foreign firms may cause governments which seek to impose some policy. The foreign firms can be expected to react to government policies in a different manner than would local firms, and may have better means for evading restrictions since they span borders and can transfer resources internally [Lessard, 1979]. Their responses may thus weaken, or even negate, the effect of policies; in fact, the policies may even give foreign firms an advantage over wholly domestic firms [Fung, 1978, and Hawkins & Macaluso, 1978].

In the non-Communist countries, governments pursue two different types of policies when they wish to introduce their priorities into the banks' decisions. They either socialize the banking system in whole or in part, or leave it in private hands but promulgate rules which constrain the banks' freedom of action. Regulations often specify the interest rates which depositors can receive or borrowers must pay. The government may require the banks to allocate credit directly. Such credit allocation is a frequent concomitant of interest-rate policies, though it may occur independently of them. We do not have sufficient information on the existence of credit allocation and interest rate ceiling policies to relate these to the degree of restrictiveness vis-à-vis foreign banks. Instead, we must make do with proxy variables. We use two: one based on the degree of government ownership of the banking sector, and one reflecting the severity of foreign exchange controls.

We would hypothesize that countries which feel that the banking system is so important to the conduct of the economy that it must be government-owned (i.e., socialized) would be highly restric-

TABLE 6

Government Ownership of the Banking System and Degree of Openness/Restrictiveness

		Socialized banking System	Government Owns Major Commercial Bank	Essentially Private
Degree of Openness/ Restrictiveness	4 + 5	4	19	40
	3	3	24	17
	1 + 2	26	3	2

$\chi^2 = 87.510$ ($p \leq 0.000$)
Cramer's V = 0.563

tive towards foreign banks.[5] Such countries might permit a limited foreign presence because of some of the other considerations discussed below, but would be careful to restrict the foreigners to just those key activities which justify their presence. The government's opposition in these cases is probably based more on the fact that the banks are private than that they are foreign.

Labelling the remaining countries as "not socialized" is too crude since this lumps together countries such as India, where the commercial banking system is some 95 percent government-owned, and others such as the U.K., where all commercial banks are publicly owned. We have therefore further differentiated the countries in this category into two: those in which the government owns a major

[5] Countries' banking systems are designated as socialized if the national government has total or majority ownership of all the commercial banks in the country, wholly or partially foreign-owned banks aside. We reserve the term "nationalized" for banking systems in which the government permits private ownership of banks, but requires that the majority of the shares be owned by local nationals. We use the terms "publicly-owned" and "private" interchangeably to designate banks that are not government-owned. Government ownership is described as such.

commercial bank and those in which it does not.[6] In Table 6 we cross-tabulate the resulting variable with our regulatory scale. There is a very strong association between the existence of a socialized banking system and the imposition of restrictions on foreign banks; however, this is essentially due to the fact that this category differentiates those countries that are closed or very restrictive from all the others (Table 6-I). Even so, if we examine the four cells in the lower right-hand corner, it is clear that countries where the government owns a major commercial bank are more likely to be restrictive than those in which it does not (Table 6-II). The measure of association used to summarize the tables is the logarithm of the odds ratio, which we will call the "log-odds."[7]

TABLE 6-I

Socialized Banking System
and Degree of Openness/Restrictiveness

	Socialized Banking System	Not-Socialized Banking System
1 + 2	26	5
3 to 5	7	100

$a = 4.308$ ($p \leq 0.000$)

[6] The basic criterion used was whether the government owned the majority of the shares of at least one of the three to four largest banks in the country, based primarily on the information in the *Banker's Directory* [Rand McNally International, 1978] and the *Government Finance Statistics Yearbook* [International Monetary Fund, 1979]. Where balance sheet data were unavailable, generally in countries with few banks, the criterion reduced to the question, "Does the government own any commercial banks."?

[7] Log odds is the term for the logarithm of the odds ratio. For two-by-two tables, a = log n11 + log n22 − log n12 − log n21 where the n's are cell frequencies. It can range between positive and negative infinity, indicating positive and negative association, respectively. A value of zero indicates independence. The variance of the log odds is given by the formula:

$$v(a) = 1/n11 + 1/n12 + 1/n21 + 1/n22$$

Since the log odds has a Gaussian distribution around its mean, one can test hypotheses such as that the observed log-odds is not significantly different form zero.

TABLE 6-II

Government Ownership and Degree of Openness/Restrictiveness

	Government Owns Major Commercial Bank	Essentially Private
3	24	17
4 + 5	19	40

$a = 1.089$ ($p \leq 0.005$)

Government ownership of commercial banks is an imperfect proxy for the desire to control since these two policies may be quite independent. On the one hand, the ownership may simply have resulted from takeover of a failed bank, or from the growth and diversification of a rural or postal savings bank system. Such banks might function in a manner indistinguishable from that of private banks, and the whole system might be marked by relatively little government direction. Austria is possibly a case in point. On the other hand, all banks might be privately owned but subject to extensive direction. Japan is an illustrative case. Given the importance, of control as a factor and the ambiguity of government ownership of the banking system as a proxy, we use a second measure, the stringency of foreign exchange controls, as a check.

Governments which are oriented towards the control of the domestic economy probably are also active in the control of foreign exchange dealings. We use as our measure of stringency the rating scheme in Pick (1981). Pick distinguishes four levels of control: free,

liberal, strict, and dictatorial.[8] Table 7 presents the cross classification with our measure of openness/restrictiveness.

There is an association which we could strengthen if we were to collapse the free and liberal categories. What is most noticeable is that no country with dictatorial controls permits any but the most limited foreign bank presence. This result is similar to that for socialization of the banking system. What weakens the further association between the two variables is that countries impose exchange

TABLE 7

Stringency of Foreign Exchange Controls
and Degree of Openness/Restrictiveness

		Stringency of FX Controls			
		Dictatorial	Strict	Liberal	Free
Degree of Openness/ Restrictiveness	4 + 5	0	17	33	11
	3	0	17	18	9
	1 + 2	14	11	5	1

$\chi^2 = 60.622 \ (p \leq 0.005)$
Cramer's V = 0.472

[8] The classification for the majority of the countries is from Pick [1981]. For those not covered, the classification is the author's of this paper, based on Pick's definitions below.
FREE CURRENCIES are units whose financial transfer to other countries is generally not bound to licenses or official permission. They are not the object of black market transactions.
UNITS UNDER LIBERAL CONTROL are currencies whose free or black market value differs, often substantially, from Official Rates. But in countries of such liberal control, ownership of foreign banknotes, bank balances abroad or gold is either legal or tolerated, and infractions of currency legislation are not punishable by jail sentences.
UNITS UNDER STRICT CONTROL are, in general, the objects of active black market transactions, have multiple official values, are surrounded by voluminous protective legislation and cannot be transferred abroad without special permits or authorization. Ownership of foreign monies or bank balances in other countries is always illegal and punishable by confiscation, heavy fines or prison sentences. Financial censorship prevents publication of black market values of strong currencies in local newspapers.
UNITS UNDER DICTATORIAL CONTROL are currencies whose Official Rates are unrealistically high and are enforced by severe legislation. Statistics concerning currency in circulation are generally a "State secret." These units are, without exception, the objects of black market transactions, which often list foreign strong currencies at extremely high premiums. Ownership of other than national units is punishable by long prison sentences or deportation to labor camps. In Russia, even death is decreed for "crimes against the national currency."

controls not only to prevent outsiders having any command over the domestic economy, but probably more frequently to stem a Balance of Payments deficit. This too might lead to some controls on foreign direct investment because of foreign firms' abilities to arbitrage controls through internal transfers. However, the magnitude of the effect is probably slight and the blocking of capital outflows motive for controls obscures the relation between the desire for control of the domestic economy as evidenced in the foreign exchange and the banking sectors.

4.2 Dependence

West [1973] distinguishes three perceptions of dependence: 1) the dominating presence of foreigners; 2) commodity composition, concentration, and technical level of developing countries' output and foreign trade compared with those of the developed countries; and 3) participation in the international capitalist system.

A concern with *dependence of the first kind* differs from a concern with control. In the latter case, it is the freedom of action of decision makers external to itself that a government wishes to circumscribe. In the former, it is the role of decision makers external to the nation that is the cause of concern.

We have no measure for dependence. It is difficult to develop an indicator because contrafactual perceptions are often involved: that is, it is believed in the country that if it were not for the restrictions, foreigners would dominate.

That it is difficult to quantify the concept does not mean that it is not important. The very fact that many countries are averse to the acquisition of major domestic banks by foreigners, while perhaps even encouraging the takeover of smaller, troubled banks, bespeaks a certain reservation.[9] We will illustrate the operation of the factor with reference to two regions (Scandinavia and Latin America) and several countries (Canada, and Morocco, Nigeria, and Saudi Arabia).

Until recently, all the Scandinavian countries (Sweden, Norway, Denmark, Finland, and Iceland) were distinctly more restrictive towards foreign-owned banks than were other European countries. Denmark is now more open, as a result of its implementation of a 1973 EEC directive.

If, for the moment, we use the six-way division of ownership restrictions as an interval scale, the average category for the

[9] For example, *World Business Weekly* [Dec. 22, 1980; pp. 51-52] reports that Credit Lyonnais' acquisition of the sixth largest Dutch bank represented something of an unprecedented intrusion. What made it acceptable was that the institution in question, Slavenburg's Bank, was experiencing difficulties. Acquisition by another of the major Dutch banks would have aggravated already high concentration in the industry.

five Scandinavian countries (including pre-1975 Denmark) is 1.4 and the mode is 1 (i.e., no foreign presence except perhaps in the form of representative offices). For the other eight EEC countries plus Switzerland and Austria, the average is 5.5 and the mode is 6 (i.e., no restrictions). The Scandinavian prohibition is long-standing and is probably due to a number of factors.[10] While none of the banking systems are socialized, the government owns a major commercial bank in four of the five countries. In Norway, parliament appoints the majority of the members of the governing body of each private bank. In addition, we suspect—without proof—that one cause of the Scandinavian countries' restrictiveness was a fear of domination by Germany and, for some, by Sweden. In our opinion, and again without proof, other European countries have solved the problem of what to do about Germany or each other by bank-level "nonaggression" pacts. There is still very little cross-FDI in banking among the countries, and far less than one would expect given the existing physical and cultural proximity.[11]

A second region in which concern for dependence may play a part is Latin America, especially Mexico and the Andean Pact countries. Here the primary concern is with domination by U.S. banks. We discuss the case of the Andean Pact in Section 4.5 below. The Mexican prohibition on foreign entry stems from the international banking crisis of the 1930s. The policy has been continued because of a fear that U.S. banks would overwhelm the smaller and less sophisticated Mexican banks and that the Mexican financial system would become simply a satellite of the U.S. financial system. The first of these concerns may be fading as the Mexican banking system becomes less fragmented and Mexican banks begin to operate abroad.[12]

The next case we discuss is that of Canada. Here too, U.S. foreign direct investment has been a major political issue for some time [Calvet, 1977]. The role of concern with dependence in the banking sector was most clearly revealed in the Mercantile Bank affair [Fayerweather, 1974 and Vorstermans, 1978].

First National City Bank (a U.S. bank now known as Citibank) acquired the Mercantile Bank from its Dutch owners in 1963. Mercantile was the smallest of the then eight chartered banks,

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[10] Wallenberg (c. 1920) reports that Sweden, Norway, and Finland forbade foreign banks to establish branches or subsidiaries. Denmark did not, but required reciprocity, and there were no foreign branches there.

[11] This may be breaking down. *World Business Weekly* (Sept. 15, 1980; pp. 50-51) reports that Deutsche Bank has opened a subsidiary in Geneva in an apparent unilateral violation of the gentleman's agreement. The subsidiary will confine itself to investment and portfolio management. Other German banks are also entering Switzerland in their own names or indirectly.

[12] In private conversation, an officer of one of Mexico's largest banks stated that in his opinion, his bank was confident of its ability to compete. He felt that the policy of restrictiveness now owed more to a general national concern with domination by the U.S. and less to any fears on the part of the domestic banks.

and the only one foreign-owned. At the time foreign banks were not permitted to open branches or agencies, and establishment of a bank subsidiary required chartering by an act of Parliament. It was clear that Parliament would not charter any foreign-owned bank, and many Canadians regarded Citibank's action as the exploitation of a loop-hole in the banking law. The acquisition gave rise to great debate and resulted in the inclusion in the 1967 Bank Act of a provision prohibiting any foreign ownership of Canadian banks in excess of 25 percent, with any one foreign shareholder being restricted to 10 percent. It is clear that much of the opposition was on nationalistic grounds and involved the fear that other foreign, and particularly U.S., banks would acquire Canadian banks. The Canadian Bank Association took no position on the issue, and the major Canadian banks individually did not oppose the acquisition.

Under the most recent Canadian Banking Act (1980), foreign banks will be able to establish banking subsidiaries. In fact, they will be encouraged to convert their existing Canadian financial subsidiaries to banks. The government is not abandoning the principle of ensuring that the country's financial system remains predominantly in domestic hands. It is imposing an overall limit on the foreign sector of 8% of total banking system assets. How it will administer this is still unclear.

Two considerations may have held the major Canadian banks from voicing public opposition to the change. First, the "big five" (of 11) are multi-nationals and the reception they receive abroad is not independent of the treatment Canada accords to the foreigners. Second, banking in Canada is highly concentrated (the top five banks had 90.4% of total chartered bank assets in 1977) and the government has become increasingly attentive to calls for more effective competition and innovation in the financial markets (Vorstermans [1978]).

Several countries where much of the banking system was foreign-owned have used forced divestiture requirements to bring about majority domestic ownership. Three cases in point are Morocco, Nigeria, and Saudi Arabia.

Prior to 1973, most commercial banks in Morocco were foreign-owned. The nationalization policy that began in that year required 50 percent Moroccan participation in all indigenous banks. In the same year, the Nigerian government acquired 40 percent of the shares of the three largest foreign-owned banks in that country. At the time, ten of the twelve commercial banks were foreign-owned. In 1977, the government promulgated a decree requiring 60 percent Nigerian ownership in all banks. While the government itself generally

acquired all the divested shares, the policy was put forward as one of nationalization rather than socialization. In Saudi Arabia the government is permitting little new entry, and since 1975 it has required foreign bank subsidiaries to sell at least 60 percent of their shares to Saudi citizens. Before the inception of "Saudi-ization," the proportion of Saudi-owned banks to foreign ones was, as in Nigeria, two to ten. In each of these cases, one might suspect that the countries have been able to pursue these policies because of an advantageous bargaining position based on natural resource wealth.

In fact, at least in the cases of Saudi Arabia and Nigeria, one can think of the nationalization as a form of "windfall profits" tax. The OPEC-engineered oil price increases have made banking in these countries suddenly very profitable. The forced divestiture provisions ensure that much of this profit goes to those nationals in a position to take up the shares, rather than to foreigners. This result is consistent with Breton's [1978] argument that the primary effect of nationalistic policies is to alter the distribution of measured wealth in favor of society's better-off citizens. The key point is that nationalistic policies may stem from parties' self-interest as well as abstract ideals.

A concern with *dependence of the second kind*--the commodity composition, concentration, and technical level of the country's output and trade—might lead to some freeing of entry. Countries might look to foreign banks to facilitate trade, provide access to international capital markets, and improve local capabilities (see sections 4.6, 4.7 and 4.9). It might also lead them to encourage the geographical expansion of one or more of their own banks to act as national "flagships." This in turn could lead to a concern with reciprocity which would also work in the direction of encouraging some reduction in restrictiveness.

A concern with *dependence of the third kind*, inclusion in the international capitalist system, must work against the government opening its domestic market to foreign banks. We have developed an indicator of anti-capitalist orientation based on type of political system. We distinguish two categories of countries: those with one-party Socialist or Communist political systems on the one hand, and all others on the other. We would argue that the former are the countries most likely to have an ideological antipathy to the international capitalist system. Table 8 presents the results of cross-tabulating this variable with our usual regulatory scale. We find the expected relationships; that is, countries with one-party Socialist or Communist regimes tend to be closed or very restrictive, and countries without such systems tend to be restrictive or relatively open.

We would also expect an anticapitalist orientation to work against the country permitting its own banks to open offices abroad, but to a lesser degree. In Table 9 we take the countries with GNPs greater than or equal to US $5 billion, and categorize them separately by their type of economy and whether or not they have one-party Socialist or Communist regimes. We then calculate the average number of branches or subsidiaries in New York or London for the countries which fall in each of these categories, relative to their GNPs. The countries in the first and fifth rows do have branches in the two centers, but the averages are notably smaller than the averages for the other categories. In part, this is because their banking systems are so highly centralized that they have relatively few banks. Even so, the differences in means are quite striking.

TABLE 8

Degree of Openness/Restrictiveness
and Socialist or Communist One-Party System

Degree of Openness/ Restrictiveness	Socialist or Communist One-Party System	Other
5	3	43
4	0	17
3	3	41
1 + 2	12	19

$\chi^2 = 50.615$ ($p \leq 0.001$)
Cramer's V = 0.606

TABLE 9

Branches or Subsidiaries in New York or London
Per U.S. $1 Bil. of GNP for Countries with GNPs of U.S. $5 Bil. or More, By Economic System and Political System

		Mean	Standard Deviation	Range	No. of Countries
Economic System	Socialist	0.04	0.04	0-0.13	11
	Capitalist Socialist	0.14	0.17	0-0.59	12
	Capitalist-Statist	0.19	0.22	0-0.86	17
	Capitalist	0.21	0.21	0-0.74	24
Political System	One-Party Socialist or Communist	0.05	0.06	0-0.21	13
	Other	0.19	0.21	0-0.86	50

4.3 The Domestic Banking Industry

A government may choose to protect the domestic banking system when it fears the effects of the competition foreign entry may bring. This leads to the questions of why a government should concern itself with the consequences of competition and why the domestic industry might be vulnerable. The two questions are interrelated. Some of the causes of vulnerability define the consequences which could follow entry. There are a number of nonexclusive situations that might lead to protection of the local banking industry—for example, when it is in its infancy, "constrained," inefficient, "overbanked," or cartelized.

Infancy is a question not so much of age as of a perceived ability to compete. If the local banks are small and technically unsophisticated, the government may, with or without their urging, decide to protect them from entry. For instance, Mexico and Norway both cite the fragmentation of their banking systems as a reason for barring

foreigners. In both countries there are a large number of small banks, though neither system is new. As discussed earlier, the authorities may also use restrictions to help create a domestically owned industry.

Our indicator of the ability of the domestic banking sector to face foreign competition is the number of banks from that country which rank among the world's top 300 [*The Banker*, June 1979]. We limit the sample to those non-Communist countries with GNPs of $5 billion or more, i.e., roughly those countries which conceivably might have banks of the requisite size. We then divide the resulting variable into two categories: one or no world-class banks, and two or more such banks. The reason for defining the categories in this manner is that the presence of only one very large bank may represent a situation of effective monopoly, with the bank being unused to the presence of rivals. We cross-tabulate the variable against the regulatory scale. As Table 10 shows, countries with two or more world-class banks tend to be less restrictive than those with fewer.

A government may also discriminate against foreign banks if its policies constrain the domestic industry. Governments frequently impose special requirements on domestic banks that limit their ability to compete with foreign banks. Credit controls or allocation schemes, or a requirement that banks grant preferential loans to local governments or nationalized industries are not uncommon. In

TABLE 10

Number of Banks in the World's Top 300 Banks
and Degree of Openness/Restrictiveness

Degree of Openness/ Restrictiveness	No. of Banks: $n \leq 1$	No. of Banks: $n \geq 2$
4 + 5	8	12
3	14	8
1 + 2	9	2

$\chi^2 = 13.828$ ($p \leq 0.001$)
Cramer's V = 0.511

effect, the government is involving the banking system in cross-subsidization, taxing some bank customers in order to provide others with services below cost. If the host government excuses foreign banks from the same requirements (perhaps on de minimis grounds), it may feel compelled to impose other constraints to approximate an overall competitive parity, or more probably, to put foreign banks at a relative disadvantage.

If the beneficiaries of the cross-subsidization policy are retail customers, especially rural ones, and the "tax" is borne by corporate customers, the implications for foreign entry are clear. Foreign banks must be excluded or restricted since one can expect them to "cream-skim." That is, they will compete in the corporate market by offering the same services as domestic banks but at a lower price. They are very unlikely to operate rural or even urban branch networks and thus at worst can keep the remaining "tax revenue" for themselves, or at best compete it away. Given sufficient foreign entry, the whole structure of subsidies and taxes would collapse, resulting either in major losses for the domestic banks or, if it is permitted, the wholesale abandonment of rural branches. The effect of these considerations can be seen in the cases of India and Australia.

In the 1950s and 1960s, the Indian government wished to encourage the extension of banking to the rural areas where the bulk of the populace lives. The private banks, which were associated with major industrial groups owned by particular families, were relatively obdurate. The government-owned State Bank of India, the largest in the country, complied with the policy; however, because it was in competition with the private banks, it could do so only to a limited degree. In 1969, therefore, the government took over the fourteen largest banks, bringing almost the entire banking system under its direct control.[13] It also banned further foreign entry and restricted the already present foreign banks to their existing number of branches. Following the 1969 socialization, there was a major increase in rural branching by all the now government-owned banks [Chitre, 1978]. In 1980, the Indian government socialized almost all the remaining private domestic banks.

In Australia, one of the major reasons put forward by the commercial banks for their continuing monopoly of full banking licenses and, in particular, of foreign exchange business is the fact that they provide an extensive network of retail banking services [McGuiness, 1979, p. 67]. Whether or not their argument is valid, one can

[13] At the time of the banking sector socialization, the State Bank of India already had a market share of 35%. The takeover brought the government another 50%. The remaining market share was split between the foreign banks (9%) and other domestic private banks (6%).

infer from the fact that the foreign banks' financial subsidiaries are very interested in entering this market that the foreign exchange business is quite profitable.

The presence in the banking system of government-owned banks can lead to restrictions for reasons other than that banks pursuing social goals are forced to compete with those pursuing private ones. An additional reason for the association between government ownership of major commercial banks and restrictiveness is that these banks may be particularly inefficient.

Crain and Zardkoohi [1980], among others, have shown that government-owned firms use more labor than do comparable private ones. Chitre [1978] found a similar tendency in the behavior of Indian banks after socialization, as well as a tendency for operating expenses per employee and per branch to increase more rapidly than the rate of inflation. Narasimhan [1978] reports that service in the socialized banks in India has deteriorated, and that customers are victims of slackness and inefficiency. More generally, Short [1979] found that government ownership was negatively related to profitability for banks from Canada, Western Europe, and Japan.

If these findings are generalizable, then for many countries permitting entry would result either in a crisis for government-owned banks or in the accrual of excess profits to foreigners. Protection, then, is a logical outcome.

A number of countries have barred new foreign bank entry on the grounds that the domestic system is in danger of being "overbanked." Basically, "overbanking" means that actual or incipient overcapacity in the industry is such that intensified competition would drive some institutions out of the market.

While banks and regulatory authorities frequently refer to the problem as a rationale for protecting a cartelized situation, there are more legitimate reasons for concern. First, failure of one bank as a result of competition could, in the absence of deposit insurance, result in a run on other banks, hence disrupting the banking system and perhaps even causing the failure or otherwise sound banks. Second, as just discussed, which banks are likely to be driven out may be an important consideration. Third, in a world of imperfect information, potential entrants may misread the market as being profitable because of their unfamiliarity with it, or its attractiveness may be a temporary phenomenon accompanying a boom. Their entry could then bring about the consequences just mentioned without effecting any offsetting benefits such as a more efficient domestic banking system. Hence, the regulatory authorities, who are charged with a concern for external

effects and who are the only party with cost and profit information on all the banks, have a duty to intervene.[14] The monetary authorities efforts to curtail a boom could bring about a credit crunch which could drive weaker banks into insolvency.

It is interesting that in several cases in the sample, closure to entry—foreign and perhaps also domestic—followed a recent increase in the number of banks established.[15] In the United Arab Emirates, a large number of foreign banks entered after the 1973 oil price increase. The monetary authorities adopted a highly restrictive entry policy affecting both domestic and foreign banks after a banking crisis in 1977, during which two banks (one local and one foreign) became insolvent.[16]

If the domestic industry is cartelized, some domestic banks may have survived despite a lack of efficiency relative to banks from more competitive countries. Cartelization may also give others excess profits. Both groups of banks would then have reason to press for protection from entry. The government may still tolerate the cartelization, even where it has not actually organized it, as a way of assuring depositor safety. It might view the costs of this policy as the price to consumers of the insurance they receive.

We have no comprehensive information on the existence of cartels. Concentration, for which data is also hard to find, only indicates the potential for cartelization, but does not prove its existence, though Short [1979] did find a positive relation between concentration and profit rates in Canada, Western Europe, and Japan. However, the effect was small, requiring large changes in concentration to change profit rates by one percentage point.

Cartels may exist without substantial concentration if the government tacitly accepts or actively sponsors them. In fact, cartelization may coexist with open entry if government requirements or a concern for "good corporate citizenship" induces entrants to join the cartel. In Hong Kong, for instance, foreign banks are members of the committee that determines interest rates, though recently there have been complaints that the cartel's rates discriminate against recent entrants [Goodstadt, 1979]. The government fostered the creation of the cartel in 1964, after interest-rate competition caused the failure of

[14] One can make even more sophisticated and justifiable arguments for entry control in general. Bittlingmayer [1981] points out that under certain conditions, no competitive equilibrium is possible. Competition will become cut-throat and the industry will be characterized by frequent bankruptcies. Kenneth Koford pointed out in private conversation that non-price competition in the form of branching may result in socially sub-optimal levels of investment. Both these approaches may have some validity for banking in general, but seem less compelling for the case of foreign banks in particular.

[15] The cases are: Bahrain, Hong Kong, Jordan, Netherlands Antilles, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[16] The two were the Ajman Arab Bank and the Janata Bank. The latter is owned by the government of Bangladesh. It has since reopened, following an infusion of capital.

several banks. As the examples of Hong Kong and Australia indicate, while cartelization may on occasion be associated with restrictiveness, it remains difficult to disentangle the cases where the operative factor is government concern for the stability of the banking system and depositor safety from those cases in which the regulators have been captured by the domestic industry.

One can argue that the capture of the regulators by the regulated in these cases is in the means of regulation, rather than in the ends. Proving the point though, requires that one show that the regulators had a choice of administrative technologies at the time the current pattern was set, and more importantly, that they have not extracted a commensurate quid pro quo.

The role of cartelization, (or, more generally, anticompetitive practices) in causing official restrictiveness is further obscured by the possibility that given the former, the latter is less necessary. In West Germany, for instance, banks may own the shares of other companies, and deal in them. They may also vote shares which as brokers they have bought for customers and which have been entrusted to them for safekeeping. As a result, bank influence over corporate policies may be quite great. Close bank-company ties make it difficult for foreign banks to make customers of major domestic corporations. Thus, while Germany is quite open as far as regulations are concerned, in actual practice it is less so.

4.4 Depositor Safety

The efficiency of the banking system as a payments system and as a source of a relatively riskless asset for households requires that retail banks be safe, i.e., have a very low probability of default. In the absence of some assurance that deposits are safe, prudence forces depositors to maintain accounts in several banks, presumably after having investigated each. This imposes extensive transactions costs on banks and depositors alike, and can be expected to reduce the utilization and utility of the banking system.

Governments have devised various ways of achieving the desired level of safety. There are a number of common ones. Frequently, the government owns the major retail banks, and especially the savings banks. It may engage in solvency regulation, that is, it may so regulate the riskiness of banks' portfolios, or the degree of leverage, as to render the probability of depositor losses effectively zero. The government may limit competition by permitting cartels or prohibiting price competition. Often, it insures deposits implicitly, either by stand-

ing ready itself to rescue any failing bank or by compelling other domestic banks to effect the rescue. One fairly rare alternative is explicit deposit insurance. Usually, the authorities pursue a mix of these policies. Even where explicit insurance is used, the fact that the banks pay a premium for the insurance that is a fixed proportion of the amount covered means that the authorities must also engage in solvency regulation as a response to problems of moral hazard [Eizenga and Giddy, 1979].

No matter which course the government pursues, the concern for depositor safety will influence its attitude towards foreign banks. First, the government will be concerned with the effect of competition on the viability of existing domestic banks, since if any fail de facto they will become a charge on the public. We have already dealt with this issue in the preceding section. Second, it will have to face the problem of the safety of deposits in foreign banks. Many countries solve this problem by limiting foreign bank access to such deposits, or by imposing more restrictive prudential requirements. Table 2 gives the various types of regulations and the number of countries utilizing each one. Some countries may impose several different types of measures.

Branches pose a particular problem for regulatory authorities since they are more or less integral parts of the parent: if the parent fails, the branch fails. It is unclear, and probably depends greatly on local law, whether local depositors would have first call on the branches' assets, or whether they would join all the other claimants against the parent and share pro rata in any recovery on the basis of the bank's total assets. While failure depends on the condition of the parent, its books are beyond the reach of local authorities.

These problems do not apply in the case of subsidiaries. The subsidiary does not fail simply because its parent has. Furthermore, the regulations governing a subsidiary are quite clear: local depositors have first call on its assets, and regulatory authorities can examine its books and operations. Of course, unlike a branch, nominally a subsidiary may fail without the parent failing. In actuality, parents usually are considered reponsible for their subsidiaries.[17] Also, failure of a subsidiary is still somewhat under the authorities' control.

In Table 11 below, we examine the relationship between restrictions on deposit taking and the forms of entry permitted foreign banks. We look only at those countries where entry in some form is

[17] After the failure of Bankhaus Herstatt in Germany in 1974, the central banks of twelve major countries met in Basle at the Bank of International Settlements to establish more explicit procedures for cooperation in the event of a crisis and formed a committee to discuss problems of international bank supervision. They agreed, inter alia, that where an overseas subsidary sustains a loss, the parent is responsible and will be supported by its central bank if necessary.

TABLE 11

Form of Entry Permitted

Form of Entry	Deposit Restrictions: No	Deposit Restrictions: Yes
Subsidiaries But Not Branches	7	1
Branches But Not Subsidiaries	1	3

$a = 3.044$ ($p \leq 0.026$)

permitted; our analysis concentrates on those where branches are authorized and subsidiaries prohibited, or vice-versa.

As the log odds indicate, there does seem to be an association between the two dimensions of the table. Of the three countries in the lower right-hand corner, two restrict foreign banks to transactions related to international trade. The one country in the lower left cell does not impose restrictions on deposit taking per se. It does, however, require higher capital adequacy ratios relative to deposits for foreign banks than for domestic ones, though the former are exempt from certain other prudential regulations.

Only 12 countries, other than the United States of America, have explicit deposit insurance or are in the process of establishing such schemes [McCarthy, 1980].[18] There is a positive association between the existence of deposit insurance and openness toward foreign banks, but it is not at all statistically significant whether one includes the countries with socialized banking systems or not. Too few countries have insurance to permit much further generalization, especially since in a number of cases the insurance is irrelevant.

In India over 90% of banking system deposits are now in government-owned institutions. In the Netherlands, the insurance

[18] The twelve are, with dates of establishment of the scheme in parentheses: Argentina (1979), Canada (1967), Chile (1977), W. Germany (1966), India (1962), Japan (1971), Lebanon (1967), Netherlands (1979), Philippines (1963), Spain (1977), Turkey (1960), and The United Kingdom (1973).

scheme is funded on the basis of ex-post assessments, reflecting the industry's view that the authorities are unlikely to allow any institutions to fail [Eizenga and Giddy, 1979]. In Japan too, the government will not permit bank failures.[19]

One can think of solvency regulation, suppression of competition, encouragement of bank mergers, etc., as ways of protecting depositors by protecting banks. One can make a good argument that this is inefficient since it protects management and stockholders, who are presumably responsible for their institution's problems, or are expected to bear risk, as well as depositors. As such, one might take the absence of deposit insurance accompanied by an unwillingness on the part of regulators to allow banks to fail as an indication of capture of the authorities by the industry. This conclusion is not clear.

Deposit insurance is a relatively new administrative technology. No country other than the United States had established such schemes before 1960, and for a third of the countries they are less than 3 or 4 years old. Rather, most countries' policies with regard to depositor safety are a consequence of massive country-wide failures, particularly in the 1930s. Only in some extreme sense were these the fault of management or owners, and at the time, only the United States authorities managed an innovative response, partially because insurance had been tried there before at the state level [McCarthy, 1980]. One has the impression that deposit insurance is only now coming to be adopted, and only in countries that are oriented towards the free operation of the market, and that are administratively capable of handling the complex bank examination required.

4.5 Relations with Other Governments

As Krasner [1976] points out with respect to international trade, openness (defined as a regime in which tariffs are falling, trade proportions are rising, and regional trading patterns are becoming less extreme) is more likely to occur during periods when a hegemonic state is in its ascendency. Gilpin [1971] argues that "politics determines the framework of economic activity and channels it in directions which tend to serve the political objectives of dominant groups and organizations" and "the multinational corporation exists because it is consistent with the political interest of the U.S." The key point is that nations do not formulate their policies in an international vacuum. Openness to foreign banks may be influenced by political, military, or economic alliances between states.

[19] Private communication from a very senior ex-official of the Ministry of Finance.

We will examine two illustrative cases: the EEC and the Andean Pact. In the first case, each member country is required to be open to entry by institutions from all other members. In the second, the policy has been one of exclusion or restriction of non-Pact member countries.

The EEC has a long-range goal of gradual harmonization of member countries' banking regulations and full mutual freedom of banking activities. While little progress has been made toward the first goal, the second has been achieved, at least nominally.[20] We would classify all the members as open, at least toward each other. Following Denmark's entry into the community, the EEC amended its bank regulations to allow foreign banks to open branches, irrespective of whether or not they were from member states. Ireland, by contrast, opened entry in branch form only to banks from countries within the EEC. Banks from other countries are restricted to subsidiaries, and are subject to operating restrictions.

Currently, Spain, Greece, and Portugal are negotiating entry into the EEC. All are restrictive but are currently amending or are expected to amend their regulations to bring them into conformity with the principle of open entry.

In 1978, the Spanish government authorized new foreign bank operations for the first time in forty years. All in all, twenty-one banks received authorization to open branches over the subsequent two years. Of these, six are from the U.S., one is from Japan, and the remaining fourteen are from the EEC. Operating restrictions are still extensive, but this may change as the Spanish banks adjust to the competition.

Following its revolution in 1974, Portugal socialized the banking system and barred further foreign entry, though the three existing foreign banks were permitted to continue operating. In December 1979, a coalition of center-right parties won the elections and formed the government, which plans to reauthorize the establishment of private banks. Foreign banks are being permitted to open representative offices, and may be allowed to establish investment companies [Caplan, 1978]. Part of the motivation for these policies is harmonization with EEC practice [*World Business Weekly*, May 13, 1980, p. 38].

In Greece, the banking system is highly concentrated, very heavily regulated, and to a great degree socialized de facto. Increasingly aware of the need to move closer to European systems as

[20] For instance, the EEC is split over the issue of secret reserves. The UK, Ireland, and Denmark object to using secret reserves to "smooth" as reported annual results. In the other six member countries this practice is widespread [*World Business Weekly*, December 22, 1980; pp. 50-51]. It is often argued that it countributes to depositor confidence in the banking system.

Greece's accession to the EEC approaches, the government has established high-level working parties to study the financial system and to make recommendations for improvements [Pryce, 1978].

The Andean Pact (Cartagena Agreement) of 1969 is an attempt to establish a regional common market among its member nations (Bolivia; Colombia; Ecuador; Peru; Venezuela; and, originally, Chile). The Andean Foreign Investment Code, an important part of the Pact, urges common adherence to strict rules which severely limit foreign ownership in key sectors, including banking. As a result, two of the current five members are virtually closed to foreign banks, and the others have imposed a variety of operating and ownership restrictions. Even so, the countries have not followed entirely consistent policies. Venezuela, the last to join the Pact, is the most restrictive. It also has the largest market and is the richest of the five. Bolivia is the most open, and the poorest. The other three fall betwen these extremes both in wealth and degree of restrictiveness. Chile, under Allende, was very restrictive. It socialized the entire banking system and expelled all but one foreign bank (Banco do Brasil). Following the overthrow of Allende, the new government withdrew from the Pact and now encourages foreign bank entry with a view to making Chile a regional financial center.

These two regional cases provide an interesting contrast. Membership in the EEC is attractive enough that various countries are willing to give up some measure of control and protection of their banking systems as part of the price of entry. The Andean Pact, on the other hand, is unable to enforce an equivalent (though opposite) subordination of national policies.

4.6 Source of Funds

Developing countries may welcome foreign banks because of the role they can play in bringing in capital. While the amounts brought in directly may be quite limited, the country may believe the banks to be catalysts for its borrowing in international markets, or for other private flows. The paragraph below is from the Bank of Thailand's 1977 *Economic Report*. It refers to the bank's decision to permit the establishment of the European Asian Bank, the first approval in ten years.

> The establishment of a branch of a German commercial bank in Thailand might bring benefits to the Thai economy, and encouraged [sic] investors from the EEC to give increased interests [sic] to Thailand. In permitting the European Asian Bank to open a

branch in Thailand, important conditions were attached, for instance, the Bank must bring in capital from its head office and/ or from the other overseas branches of bank not less than B[aht] 100 million within a period of two years, and on the opening day the Bank must have brought in at least B 50 million to be maintained as assets as stipulated.

If a country has access to world capital markets, it can afford to be more restrictive towards foreign banks than if it does not. Lees and Eng [1979] used various economic criteria to group some fifty-one developing countries into four categories in terms of their increasing ability to tap various sources of international funds. In Table 12 we compress the four access and the five regulatory categories into two each. As the log odds show, there is a statistically significant negative relationship between the two dimensions. In the sample, LDCs with greater access to international capital markets are freer to restrict foreign banks than are those with less.

TABLE 12

LDC Access to World Capital Markets
and Degree of Openness/Restrictiveness

		Access	
		High	Low
Degree of Openness/ Restrictiveness	4-5	6	13
	1-3	20	9

$$a = -1.572 \ (p \leq 0.001)$$

4.7 Trade Promotion

It has often been contended [e.g., Grubel, 1977], and it now appears that there is evidence that banks follow trade [Terrell, 1979; and Tschoegl, 1979]. Banks can also facilitate trade by acting as conduits for market information, and through their financing and operational activities (letters of credit, bankers' acceptances, money movement, etc.). Countries concerned with expanding exports may therefore welcome foreign banks, at least as long as they limit their activities (or are restricted) to international business. The most striking examples of the operation of this factor involve three Communist countries: The People's Republic of China, Rumania, and Hungary.

When the Communists took over China in 1949, they permitted four banks to maintain one branch each in Shanghai.[21] These branches continued to operate even during the Cultural Revolution. Very recently, the government has allowed several additional banks to open representative offices.

Rumania is the only other Communist country which permits foreign-owned banks to open branches. Only one U.S. bank has taken advantage of this opportunity, and it is restricted to hard currency transactions for the sole purpose of facilitating foreign trade.

TABLE 13

Ratio of Imports to GNP and Degree of Openness/Restrictiveness

Degree of Openness/ Restrictiveness	R ≤ .2	.2 ≤ R < .4	R > .4
5	8	16	20
4	3	10	4
3	12	19	15
1 + 2	13	13	4

$\chi^2 = 18.932$ ($p \leq .005$)

Cramer's V = 0.273

[21] The four are: Chartered Bank, a British overseas bank with wide representation in Asia and which is part of the Standard Chartered Group; Bank of East Asia, from Hong Kong; Hongkong and Shanghai Bank, another British overseas bank, but with headquarters in Hong Kong; and Overseas Chinese Banking Corporation, from Singapore.

Hungary has just authorized the establishment there of a majority foreign-owned joint venture. The Hungarian partner, the National Bank of Hungary, has the largest shareholding (34 percent). The foreign participation is split equally among six banks, two from Japan and four from various European countries.[22] The bank will concentrate primarily on trade-related activities.

More generally, we have developed a variable for the importance of trade, particularly imports, to the national economy. The variable categorizes the ratio of imports to GNP. The dividing points were chosen to yield three categories with roughly similar number of countries in each. While neither the chi-square statistic nor the degree of association in Table 13 is impressive, the direction of the relationship is as hypothesized.

4.8 Reciprocity

A country may open its market to foreign banks because it wishes to gain access to foreign markets for its own banks. A number of countries require such reciprocity either explicity in their laws or implicity in their approval practices. Some countries, particularly those that wish to be the home for an international financial center, do not insist on reciprocity at all (e.g., the U.K.). For many, the whole question is irrelevant since they have no domestic banks willing or able to expand abroad. For those concerned with the issue, the definition of reciprocity they adopt cannot be independent of their domestic policies towards foreign banks.

The first, and potentially the most restrictive, definition is similar to a "Most Favored Nation" clause in trade agreements. Each country merely agrees, often implicitly, not to favor banks from one country over those from any other. Even this basic principle is occasionally violated.[23]

The second is a "tit-for-tat" approach. Country A permits country B's banks entry if its own may establish themselves in country B. Some countries insist on some form of numerical parity, i.e., a branch-for-branch rule. This provides them with a mechanism for restricting entry, as well as gaining it. Brazil, for instance, argues

[22] The six are: Creditanstalt Bankverein (Austria), Banca Commerciale Italiano, Long Term Credit Bank (Japan), Taiyo Kobe Bank (Japan), Société Générale (France), and Bayerische Vereinsbank (W. Germany). In addition, Société Générale, Banque Nationale de Paris, Creditanstalt Bankverein, Banco di Sicilia, and National City Bank of Minneapolis are reported to have representative offices in Budapest.

[23] Qatar, for instance, follows the practice of placing government funds with local banks, British banks, and other foreign banks, in that order. Gabon, on the other hand, favors French banks. As we noted earlier, Malaysia bans foreign banks that are government-owned. Obviously, this will have a differential impact depending on the nature of the banking system in each potential home country.

that since U.S. banks have some fifty-six branches there, and its banks have only ten in the U.S., it is actually more than accommodating, even though it has permitted almost no new entry since 1964. Interestingly enough, in 1980 Brazil and Venezuela, by special agreement, each permitted one bank from the other country to open a branch.[24]

The third definition is that of "national treatment," i.e., the absence of discrimination in law or practice between foreign and domestic banks. While a "Most Favored Nation" approach is consistent with any domestic policy towards foreign-owned banks, a demand for "national treatment" requires a similar domestic policy.

Finally, the fourth definition is that of "home country powers." This is the doctrine that Country A's banks should have the same powers in Country B that B's have in A. Such an approach is really only open to countries whose domestic banking sectors are relatively unregulated. They can then justify less-than-national treatment of foreign banks and entry restrictions, since few countries would reduce their domestic regulatory practices to this lowest common denominator. Switzerland, to the best of our knowledge, is the only country that has adopted this approach. Its major commercial banks have few branches or subsidiaries outside of major world financial centers and are not concerned with expanding their access, but rather with limiting competition at home.

We can get some indication of the role of reciprocity by calculating, for each category of our regulatory typology, the mean of the number of banks from a country with a direct presence in London or New York, relative to its GNP. Again, we consider only those countries with GNPs of $5 billion or more to eliminate those for whom the question is irrelevant. As Table 14 shows, there is a clear association between a country's openness to foreign banks and its representation in the two financial centers.

A concern with reciprocity may drive a wedge between those domestic banks that can take advantage of the opening of foreign markets and are secure in their domestic position, and those that see only the increased competition. A country's position on the issue of reciprocity will then depend in part on the political strength of the two groups. One possibly important factor is into which group the government-owned banks (if any) fall. Unfortunately, we have no data that would enable us to pursue this further.

[24] The two banks were Banco do Brazil and Banco Union.

TABLE 14

Branches or Subsidiaries in New York or London
Per U.S. $1 Bil. of GNP for Countries with GNPs of U.S. $5 Bil. or More, By Degree of Openness/Restrictiveness

		Mean	Standard Deviation	Range	No. of Countries
Degree of Openness/ Restrictiveness	5	0.20	0.22	0-0.86	23
	4	0.24	0.21	0-0.59	7
	3	0.19	0.23	0-0.74	12
	1 + 2	0.06	0.09	0-0.35	20

4.9 Enhancement of Domestic Financial Markets

A government may permit entry by foreign banks to increase domestic competition and to introduce new capabilities to the local financial markets.

Domestic banks may even welcome foreign bank entry, or at least not oppose it, for three reasons. First, there is the question, just discussed, of gaining reciprocal access to other markets. Second, the banks may be politically vulnerable to charges of attempting to protect a cartel. We have already discussed both of these considerations with respect to Canada in Section 4.2 above. The third reason is that having ready access to a large number of sellers who offer somewhat different products reduces search costs for buyers. Foreign banks are particularly likely to offer different products, since their knowledge, methods, and policies will not be the same as those of domestic banks. Search costs are analogous to a tax, and reducing them is equal to an outward shift of the demand curve facing the sellers, in this case the banks [Stuart, 1975]. Hence, the following statement: "While foreign banks may be more competition, they bring more business for everyone."[25] Because of the positive externalities generated, one could even argue that regulators should offer foreigners inducements to enter. If necessary, these could include subsidies and freedom from some regulations imposed on domestic banks.

[25] Earnest Schneider, EVP, Irving Trust, quoted in *American Banker*, Aug. 8, 1977, p. 13. in reference to foreign banks in New York.

Spain provides an illustrative case of the role of the desire to enhance the domestic financial sector. Following the death of General Franco, and especially since the elections of June 1977, the Spanish government has moved to modernize the economy, particularly the banking and financial sectors [Muns, 1978]. It has freed certain interest rates and reduced the required ratio of investment in public and privileged activities. Savings banks are permitted to engage in the same activities as commercial banks. In addition, as discussed earlier, the government has started to authorize foreign bank entry to increase the competitiveness and efficiency of the local banking system. To ease the transition, foreign entry is being phased in gradually, and is surrounded with restrictions. As far as the government is concerned, there is clearly no need to induce the desired amount of entry. Moreover, the government seems committed to further liberalization, in spite of domestic pressures to the contrary.

It permitted Barclay's Bank, the only bidder, to purchase the ailing medium-sized Banco de Valladolid. On the other hand, pressure from domestic bankers forced the government to block New York's Citibank from buying into ICI, Spain's second-largest financial house (*World Business Weekly*, March 23, 1981).

While foreign banks' activities are concentrated on the wholesale end of the market, banking as a whole is becoming more competitive. The foreigners also succcessfully launched an acceptances market and have introduced the use of floating rates (*World Business Weekly*, April 13, 1981; p. 29).

One can speculate that the domestic banks were not able to block all foreign entry for two reasons. As discussed in Section 4.5 above, Spain wishes to join the EEC and openness is one of the prices it will have to pay. In addition, its willingness to inflict some losses on the banking sector may not be independent of the fact that this has long been one of Spain's cosiest business cartels and was particularly associated with the Franco regime.

4.10 Creation of a Financial Center

A country may wish to establish one of its cities as an international financial center. The gains would include tax revenues, balance-of-payments effects from the banks' earnings, employment, and reduced transactions costs, primarily for corporate users of financial services. Johnson [1976] estimated the employment and income effects for Panama but found them to be slight. McCarthy [1979]

distinguishes two types of centers—"paper" and "functional." The former provide locations of record but no actual banking takes place in them. In functional centers, banks make loans and take deposits, though these may appear on the books of a branch in a paper center. McCarthy finds that the benefits to the host of the first type are limited to fees and the sums involved are minor. Functional centers are more advantageous to the sponsor, but the net effect is still limited because of the costs of providing the necessary infrastructure.

Nevertheless, the benefits are attractive to countries with limited alternatives. Of the sixteen offshore centers we can identify, ten are island-states and all the others are small, developing countries, except for Luxembourg which is simply small.[26]

The enticement of foreign banks would involve the country in competition with other countries in the areas of freedom from regulation [Giddy and Allen, 1979] and minimization of fees and taxes imposed. This does not necessarily mean that the country must change its policies towards its domestic market.

Several countries have completely separated the international and domestic markets by authorizing foreign banks to establish Offshore Banking Units. These branches generally are permitted little or no contact with the domestic market, but are given relatively wide latitude in their international activities. Of the four countries that authorize OBUs, none permits foreign banks to open branches or to have majority-owned subsidiaries to serve the local market.[27] The other eight off-shore centers discussed by McCarthy and for which we have data from the Comptroller's report we would classify as being relatively open or open. Three are currently closed to all new entry because the authorities feel there are now enough banks. Even these, however, were formerly open, and there do not seem to be any operating restrictions.

---

[26] Islands: Anguilla, Bahamas, Bahrain, Cayman Islands, Hong Kong, Jersey, Netherlands Antilles, New Hebrides, Seychelles, and Singapore. Others: Lebanon, Luxembourg, Panama, the Philippines, Tunisia, and the United Arab Emirates. Sri Lanka, a small, developing country and an island is now also interested in drawing some international banking activity.

[27] The four are: Bahrain, the Philippines, Singapore, and Tunisia.

5. Conclusions: The Structure of National Political and Economic Systems and Its Influence On Openness

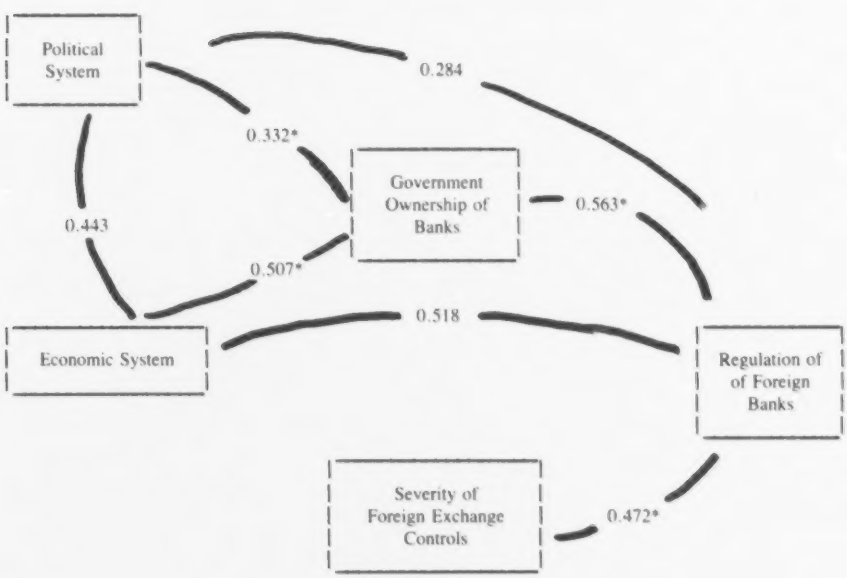
In this section we discuss primarily the interaction between the countries' political and economic systems, their governments' desire for control (as proxied by ownership of the banking system), and the regulation of foreign banks. In Figure 2, we diagram the degree of association between these variables. The numbers on the lines are the values for Cramer's V from the relevant cross-tabulations. Those marked with an asterisk are from Tables 6, 15, and 16. The others are from tables not presented in the paper.

First, we will discuss the relationships in the figure. Then we will consider some of the factors that we have discussed earlier.

A country's philosophy about the role of the state has an effect on its desire to control banking. We would argue that one of the operative factors is the nature of the political system and its tolerance for pluralism. In Table 15, we cross-classify countries by their political

FIGURE 2

Interactions



system and by the degree of government ownership of the banking system.[28] As the table indicates, there is a statistically significant relationship between the two dimensions. There are only two countries (Portugal and Nepal) with a completely socialized banking system and a multiparty political system. There are many countries which have more restrictive political systems but perhaps extensive private sectors. Finally, there are two countries (Burundi and Zambia) with one-party socialist or communist systems, but which permit banking to remain essentially in private hands.

Next, we cross-classify countries by their economic system and the degree of government ownership. Following Gastil [1978, pp. 43-51], we distinguish four types of economic systems: capitalist, capitalist-socialist, capitalist-statist, and socialist.

Gastil develops a four-fold typology of economic systems: capitalist, capitalist-statist, capitalist-socialist, and socialist. The

TABLE 15

Government Ownership of the Banking System and Political System Type

		Government Ownership		
		Socialized Banking Sytem	Government Owns Major Commercial Bank	Essentially Private
Political System	Multi-Party	2	21	30
	Other	23	21	23
	One-Party Socialist or Communist	10	3	2

$\chi^2 = 29.684$ ($p \leq 0.000$)
Cramer's V = 0.332

[28] As far as political systems are concerned, Gastil [1978, pp. 43-51] recognizes four major types, with seven subtypes. For our purposes, we distinguish only two: the multiparty category, and the socialist or communist one-party system category. Whenever we use either of these categories, all other systems are thrown into a residual category. Multiparty states do not include those where one party so dominates that any and all other parties exist in little else but name.

TABLE 16

Government Ownership of the Banking System and Economic System

		Government Ownership		
		Socialized Banking System	Government Owns Major Commercial Bank	Essentially Private
Economic System	Capitalist	1	24	34
	Capitalist-Socialist	10	7	13
	Capitalist-Statist	6	14	9
	Socialist	18	1	0

$\chi^2 = 70.496$ ($p \leq 0.000$)
Cramer's V = 0.507

characterizations are impressionistic and the dividing lines are necessarily arbitrary. In capitalist states, there is a general reliance on the operation of the market and on private provision for individual welfare. Capitalist-statist governments own very large productive enterprises and intervene in the economy in a major way, but not primarily on egalitarian grounds. Capitalist-socialist systems provide social services on a large scale, with the result that some private control over property is sacrificed. In Socialist states, the government strives programmatically to place the entire national economy under its control.

Our hypothesis is that as we go from capitalist to socialist, governments will be more concerned with detailed direction of the economy, and thus with any lack of control that a private or foreign bank presence might bring. The results in Table 16 are consistent with this view.

While Gastil does not make this entirely clear, the typology actually reflects two dimensions—one involving the degree to which the government directs the economy, and the other its commitment to redistribution on egalitarian grounds. Thus, following the first dimension, we would group the capitalist and capitalist-socialist types on the one hand, and the capitalist-statist and socialist types on the

other. On the second dimension, we would group capitalist with capitalist-statist types, and capitalist-socialist with socialist types.

Doing so yields Tables 16-I and II. These reveal that our initial hypothesis and table masked this important distinction. While there is still an association between a governmental orientation towards control of the economy and ownership of the banking sector, this is not as strong as that between the latter and a concern with redistribution. Presumably then capitalist systems are particularly open, and socialist ones particularly closed since they are respectively low and high on both dimensions.

A country's political and economic systems are related, though not necessarily very strongly. On the one hand, of the twenty-seven countries that have socialist or communist one-party systems, or socialist economies, eighteen fall into both categories. On the other hand, capitalist economic systems are consistent with a variety of political systems.

The effect of a country's political system does not seem very strong, at least relative to that of the economic system. This is not quite correct, since as we have seen in Table 8, one-party socialism or communism is strongly related to closure to foreign banks. For countries with other types of political systems, though, it is the view of the role of the government as revealed in the economic system that is important.

It is these basic political-economic orientations that determine if some of the other considerations discussed earlier come into play. If a country bars all private banks, it need not concern itself with dependence, the ability of its banks to compete, the effect of entry on the domestic banking system, depositor safety, or the enhancement of domestic financial markets. Only when a country is basically willing to allow private banks to operate does it have to face the question of extending this right to foreign-owned institutions. We can therefore think of the cost-benefit calculus as being a second step, conditional on the country's basic orientation. Those countries that wish to have socialized systems may nevertheless permit some entry because of the role of foreign banks in facilitating trade. Those that permit the existence of an extensive private banking sector may, however, be very cognizant of the costs of foreign entry.

Dependence emerges as one of the most important of these "second-stage" cost considerations. A fear of the dominating presence of foreigners and the perceived ability of domestic banks to compete are inversely related. Even so, objective measures and the perceptions of the government or the populace at large may be at

variance with each other. In fact, the real situation may be irrelevant. Given the importance which governments and people attach to the banking sector, close proximity to particular foreigners may lead to policies of closure despite the country's basic political-economic orientation or the capabilities of its own banks.

These considerations give rise to the following simplified

TABLES 16-I & II

Government Ownership of the Banking System
and Orientation of the Economic System

TABLE 16-I

			Socialized Banking Sytem	Government Owns Major Commercial Bank	Essentially Private
Control Orientation	Lo	Capitalist & Capitalist-Socialist	11	31	47
	Hi	Capitalist-Statist & Socialist	24	15	9

$\chi^2 = 26.261 \ (p \leq 0.005)$
Cramer's V = 0.438

TABLE 16-II

Redistribtion Orientation	Lo	Capitalist & Capitalist-Statist	7	38	43
	Hi	Capitalist-Socialist & Socialist	28	8	13

$\chi^2 = 40.710 \ (p \leq 0.005)$
Cramer's V = 0.545

model. We can think of each country as asking itself three questions, in order:

Q1. Will we permit domestic private ownership in the domestic banking sector?
Q2. Will we permit foreign ownership in the domestic banking sector?
Q3. Given our answer to one and two above, do the remaining benefits outweigh the remaining costs, or vice-versa?

If the country's answer to either of the first two questions is "No," then one can expect that it will be at best restrictive towards foreign banks, and probably closed. If its answer to both of the first two is "Yes," then it will probably be open. In either case, the degree of restrictiveness, i.e., distance from the extreme position, will depend on the country's assessment of its answer to the third question, the residual cost/benefit considerations. Note that in the first question we have qualified private ownership with the word "domestic." In general, as we have assumed throughout this paper, a government's primary concern is whether it can accomodate the existence of a locus of control outside itself. If it cannot, then it does not matter whether this would be domestic or foreign. In some situations though, a government may be comfortable with the presence of foreign banks but not with that of domestic private ones.[29]

The foreigners may be held by law or economics to a relatively small role in the economy. However, domestic private banks are often parts of a small number of family-owned financial/industrial/commercial groups with a great deal of power, particularly in developing countries [Leff, 1976]. In these cases, and Portugal may well be an example, a revolutionary regime will socialize the banking system, while leaving the few foreign-owned institutions alone.

As a final qualification of the simple model, we must note that as far as the second question is concerned, not all foreigners are equally welcome or unwelcome. Countries may, in practice, be able to discriminate between origins. An international regime (rules of the game) that would permit them to do so might even result in greater total world openess than one that required non-discrimination.

The model suggests that one can decompose what is commonly termed "political risk" into three components: political philosophy, xenic, and industry risk. Each of these refers to changes in a country's response to the three questions above, respectively. The risk is the consequences for a foreign company's operations of a change in the regulatory environment accompanying the new answers.

[29] I would like to thank Stephen J. Kobrin for forcing me to accept this point.

While we have not specifically examined the process of change in regulations in this essay, the cases and the model suggest some hypotheses.

1). Industry Risk. One can expect residual costs and benefits to change slowly over time. This will give rise to incremental regulatory changes which will take some time to occur and will probably give warning of their arrival from developments in the banking sector. One can also expect that a country's position on the first two questions will influence its reactions to new situations with respect to the third. Changes in the direction of the "home" pole are more likely to come about than those away from it, and to arrive more quickly.

2). Xenic Risk. We have no prior expectations about the time behavior of changes in a country's attitudes towards foreigners. These might be slow as a particular country's hegemony waxes and wanes, or might be quite rapid as with a wave of nationalism. In general, we would expect rapid changes to accompany changes in the response to the question of private ownership.

3). Political Philosophy Risk. Radical changes, i.e., those involving a switch in attitudes towards private ownership, will probably occur rarely, but quickly. They will accompany a major change in the make-up of government, especially due to a revolution. In democratic states, such a major change might occur after a party attains power after a long period, perhaps several decades, in opposition. These non-incremental changes will derive from macro-political changes in the country, and will give their warning, if at all, in areas outside the banking sector and frequently outside existing political and economic elites.

If these hypotheses are correct, they have implications for lobbying efforts by foreign banks or governments seeking a more liberal regime. Inducing a country to change its effective polarity would seem to be very difficult, if not impossible. Even efforts to encourage a closed country to become slightly more open would require great effort for small return. Encouraging a relatively open country to become more open would seem to hold more promise.

The first direction for further research is to improve the methods for measuring openness and restrictiveness, the desire for control, and the fear of dependence. With better measures of these variables the model can be improved. With better data and a better model, we can then proceed to investigate the dynamic hypotheses which we have just proposed.

Appendix

Country Ratings (1979-1980)

1.	Afghanistan	1	
2.	Algeria	1	
3.	Argentina	5	
4.	Australia	3	
5.	Austria	5	
6.	Bahamas	5	
7.	Bahrain	3	
8.	Bangladesh	2	
9.	Barbados	5	
10.	Belgium	5	
11.	Belize	5	
12.	Benin	1	
13.	Bermuda	3	
14.	Botswana	5	
15.	Bolivia	4	
16.	Brazil	3	
17.	Bulgaria	1	
18.	Burma	1	
19.	Burundi	5	
20.	Cameroon	3	
21.	Canada	3	
22.	Rep. of Cape Verde	5	
23.	Cayman Is.	5	
24.	Central African Empire	4	
25.	Chad	NA	
26.	Chile	5	
27.	People's Rep. of China	1	
28.	Columbia	3	
29.	People's Rep. of the Congo	3	
30.	Costa Rica	3	
31.	Cuba	1	
32.	Cyprus	4	
33.	Czechoslovakia	1	
34.	Denmark	5	
35.	Rep. of Djibouti	5	
36.	Dominican Rep.	3	
37.	Ecuador	3	
38.	Egypt	2	
39.	El Salvador	3	
40.	Ethiopia	1	
41.	Fiji	5	
42.	Finland	3	
43.	France	5	
44.	Gabon	5	
45.	The Gambia	3	
46.	German Dem. Rep.	1	
47.	Fed. Rep. of Germany	5	
48.	Ghana	3	
49.	Greece	4	
50.	Guatemala	3	
51.	Guinea	1	
52.	Guinea-Bissau	NA	
53.	Guyana	3	
54.	Haiti	3	
55.	Honduras	5	
56.	Hong Kong	5	
57.	Hungary	2	
58.	Iceland	3	
59.	India	3	
60.	Indonesia	3	
61.	Iran	1	
62.	Iraq	1	
63.	Rep. of Ireland	3	
64.	Israel	5	
65.	Italy	5	
66.	Ivory Coast	5	

Appendix (cont.)

Country Ratings

67. Jamaica	5	105. Qatar	3
68. Japan	4	106. Romania	2
69. Jordan	5	107. Rwanda	5
70. Kenya	5	108. Saudi Arabia	3
71. Kuwait	2	109. Senegal	5
72. Laos	2	110. Seychelles	5
73. Lebanon	4	111. Sierra Leone	5
74. Lesotho	5	112. Singapore	3
75. Liberia	4	113. Solomon Is.	3
76. Libya	1	114. Somalia	3
77. Luxembourg	5	115. South Africa	3
78. Madagascar	1	116. South Korea	3
79. Malawi	4	117. Spain	4
80. Malaysia	3	118. Sri Lanka	5
81. Mali	5	119. Sudan	4
82. Malta	3	120. Surinam	4
83. Mauritania	5	121. Swaziland	5
84. Mauritius	5	122. Sweden	1
85. Mexico	3	123. Switzerland	5
86. Morocco	3	124. Syria	1
87. Mozambique	2	125. Taiwan	4
88. Nepal	1	126. Tanzania	1
89. Netherlands	4	127. Thailand	4
90. Netherlands Antilles	5	128. Togo	5
91. New Zealand	3	129. Trinidad and Tobago	3
92. Nicaragua	NA	130. Tunisia	3
93. Niger	3	131. Turkey	3
94. Nigeria	3	132. United Arab Emirates	5
95. Norway	1	133. United Kingdom	5
96. Oman	5	134. U.S.S.R.	1
97. Pakistan	4	135. Upper Volta	4
98. Panama	5	136. Uruguay	3
99. Papua New Guinea	4	137. Venezuela	3
100. Paraguay	5	138. Yemen Arab Rep.	5
101. Peru	3	139. Yugoslavia	1
102. Philippines	3	140. Zaire	3
103. Poland	1	141. Zambia	5
104. Portugal	1		

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